Canada

Submission to the Royal Commission on Banking and Finance

Summary

July, 1962

The Canadian Bankers' Association

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INTRODUCTION

1. The chartered banks of Canada wish to commend the members of the Royal Commission for undertaking the onerous duties of this most important enquiry and to express the hope that their efforts will result in measures of lasting benefit to Canada as a whole. For their part the banks have given their full co-operation in furthering the study in which you are engaged, and hope in presenting the brief which follows that the facts and opinions set out will be of material assistance in your deliberations. The brief does not pretend to offer definitive answers to all the questions it raises, because these matters carry well into areas where value judgments must be made between alternative objectives and where it would be neither possible nor desirable for the chartered banks as a whole to speak with one voice. However, any specific proposal that is advanced in this brief has the support of the banks generally.

2. The brief begins with an outline of the chartered banks' views about the general framework of monetary and fiscal policies, and about the overall financial framework within which the banks must operate. Next comes a description of the principal operations of the chartered banks, which covers bank cash reserves, investments, loans, deposits, earnings, capitalization, and related topics. After that there is a discussion of broader financial topics, including competition among banks, competition with other institutions, interest rate policies, and certain central-bank control techniques. The recommendations the chartered banks wish to make are included in the course of the presentation as they arise naturally out of the discussion.

THE ROLE OF FINANCIAL ORGANIZATIONS

Policy Objectives

3. The most generally accepted economic objectives are full employment, stable domestic prices, healthy economic growth, and a sound and dependable relationship between the domestic economy and the world economy of which it is a part. In pursuance of these objectives it may be taken as a general principle that the methods used should be those of the normal price and market mechanism as far as possible, or at least should be compatible with the effective operation of that mechanism.

4. However, it is also generally recognized that the attainment of these various objectives may at times interfere with one another. Where a choice has to be made between conflicting or partly conflicting objectives it is proper in these situations for the choice to be made by the Government, as the responsible elected representatives of the Canadian people.

5. Monetary policy and fiscal policy are generally thought of as the two main instruments available to the authorities for pursuing the major economic objectives described above. When properly used they are compatible with the price and market mechanism; indeed, smoothly operating financial markets are important to the optimum effectiveness of both monetary policy and fiscal policy.

Other Policy Instruments

6. It is quite possible that there is too much concentration on monetary and fiscal policies, as if they were the only means of promoting the desirable economic objectives discussed earlier. In point of fact there is a wide range of additional measures that can be employed to good effect, for example, public debt management, taxation policy, commercial, tariff, and exchange rate policies, and measures to encourage increased productivity. However, this brief must be concerned primarily with monetary matters.

The Role of Finance

7. One of the major functions of the financial system is to mediate between those who do not wish or are not able to invest their savings directly in physical assets and those who draw on the savings of others to supplement their own resources. A substantial portion of this mediation takes place through the arrangement of loans or the purchase and sale of securities between principals, either in direct negotiation or in transactions through investment dealers and brokers on organized or over-the-counter markets; it may involve the issue of new securities or loan contracts or other types of financial claims, or trade in existing claims. Another major portion takes place through various financial institutions, such as banks, trust companies, mortgage loan companies, credit unions, insurance companies, finance companies, small loan companies, factoring companies, and others, which receive funds from one group and lend to another and accordingly may be described as financial intermediaries.

8. The importance of effective financial organization is implicit in the need to maintain a balance between the community's investment demands and the flow of savings it tends to generate when all its resources are fully employed. Any tendency to imbalance in this relationship will make itself felt in financial terms, and so must any measures taken to correct such a tendency. Both monetary and fiscal policies operate by influencing one side or the other of this relationship as reflected in the supply of and the demand for financial claims. Sound and responsive financial institutions and financial markets are thus essential to the use of these policies for promoting Canada's major economic objectives.

9. Until fairly recent years it was generally held that banks were categorically different from other financial institutions in that the former could "create" credit whereas the latter

could only re-lend funds entrusted to them. Even today there are those who maintain this position. However, an increasingly influential body of opinion now holds that credit "creation" is not peculiar to the banking system, but occurs in basically the same form in various parts of the financial structure. The emphasis is placed on the general liquidity of the economy, not on the quantity of money alone. It is argued that the total resources available to the capital market and to all financial institutions combined is determined by the laying aside of financial savings out of income, and that the allocation of these resources to banks and to other financial institutions is determined by the free choice of savers in deciding how to employ their savings. The distinction between banks and other financial institutions lies not in any mysteriously different source of resources but in the ready acceptability of bank deposits by spenders and savers alike; bank deposits are a particularly attractive form of liquid asset because they are a means of payment and hence are useful not only as a savings vehicle (liquidity motive) but also as working balances (transactions motive).

10. It is of course technically true that the Canadian banking system can expand its assets (in the form of loans or investments) and its liabilities (in the form of deposits) within limits fixed by the amount of cash reserves the Bank of Canada allows them. However, the banks themselves cannot determine these limits. It is entirely within the power of the national monetary authorities to decide what level of bank deposits is appropriate

11. The object of the authorities in using monetary and fiscal policies must be to maintain a balance between the economy's investment demands and its rate of saving at optimum levels of income, taking account of the limitations of these policies themselves This means maintaining the smooth flow of the spending stream as a whole. From this point of view it makes no difference whether a loan-financed expenditure is made possible by the expansion of

the money supply (quantity of money) or by more intensive use of the existing money supply (velocity of circulation), for both affect the spending stream. It is clear therefore that the authorities should be concerned with all forms of credit, including that granted by other financial intermediaries as well as by banks and including that obtained through the money and capital markets.

12. The type of lending business carried on by the various financial intermediaries should not be determined by arbitrary rules, but should be left to the play of market forces and natural specialization. Institutions with long-term contracts predominating among their liabilities, such as life insurance companies and pension funds, may be expected to seek relatively long-term outlets for their funds, including bonds and mortgages, though of course they will need some shorter-term and therefore more liquid assets as well in order to allow for unexpected variations in their cash flows. Institutions that are designed to provide specialized forms of credit, on the other hand, such as finance and factoring companies, etc., may try to raise funds through contracts with maturities more or less comparable to their loan contracts. In general, however, there is no compelling reason for having precisely matching maturities in the borrowing and lending contracts of the same institution, provided a liquid reserve is maintained that is adequate to the risks involved and provided also that the asset "mix" is appropriate to the fundamental nature of the business.

13. In the case of banks it was formerly thought necessary that they should confine their loans and investments to short-dated maturities, because their obligations are repayable on demand. Nowadays, however, , it is recognized that it is feasible for them to put a limited portion of their funds into longer-dated loans and investments. Nevertheless it remains true that the first priority in bank lending must still be given to short-term

business borrowing for working capital purposes, because the banking system in Canada, as in most other parts of the world, developed in response to these needs and there appears to be no other source similarly qualified to provide, administer and supervise this type of loan.

The Role of the Banking System

14. Banks are clearly financial intermediaries, and clearly have a special role to play in the functioning of the financial system. However, while "a bank" in popular understanding is a specific and readily identifiable type of institution, it is not easy to find a satisfactory definition -- a problem that is by no means peculiar to Canada. The Bank Act gets around the difficulty by defining a bank as "a bank to which this Act applies" (s. 2), i.e. "each bank enumerated in Schedule A" (s. 4), but that leaves the real question unanswered.

15. It seems impossible to define banking in a way that meets universal acceptance. In what follows, unless otherwise indicated by the context, the word "bank" will be synonymous with "chartered bank" and will be used in the sense in which it is defined in the Bank Act.

16. Just as one of the recognized key functions of a central bank is that of lender of last resort for the commercial banking system, so the commercial banks in turn perform a similar function for other financial intermediaries, though this is probably less well understood. These institutions typically carry working balances with the banks, just as other businesses do. They also customarily maintain lines of credit with their banks, whereby they are able to borrow on short notice within agreed limits. In this way they are able to operate with minimum working balances and yet with reasonable assurance of being able to meet any unexpected demand for funds. The liquidity of the entire financial structure thus depends largely on the liquidity of the banks.

17 Modern views of the respective roles of banks and other institutions within the financial structure differ substantially from those of even a generation ago, and indeed one of the most important tasks before the Royal Commission may be that of putting these relationships in better perspective. Without trespassing on the ultimate findings of the Commission in this respect, however, it may be said that the present-day questioning of older ideas in this field does not detract from the key role of the banking system in maintaining a balance between the saving and investment decisions of the community. When business is slack the almost universal acceptability of bank deposits by spenders and savers alike assures the community of whatever degree of liquidity may be necessary to sustain business operations. In times of inflationary boom the dependence of a community on money as the means of effecting transactions offers the authorities a powerful and flexible weapon for keeping the volume of spending in line with the physical volume of goods and services becoming available.

18. For their part Canadian banks from earliest days have recognized the need to co-operate with official financial policies in the public interest. They recognize this need no less now, because of the key position of the banking system in carrying out such policies in promoting economic stability.

19. It is therefore submitted that the public interest is served by the existence of a strong banking system. A bank is more than a repository of deposits on the one hand, and a medium for making loans and investments on the other. The fact that the deposits entrusted to the chartered banks are the banks' liabilities to the public is an accounting truism, but its real significance tends to be overlooked or taken for granted. Not since 1923 has there been a bank failure in Canada. Thus, for a generation, no Canadian has lost a night's sleep worrying about the safety of his "money in the bank". Indeed, the Canadian banking system

enjoys a world-wide reputation for soundness and stability, and this in itself has been a factor of no small significance in the nation's economic development.

THE OPERATIONS OF THE CHARTERED BANKS

Reserves

20. The pivot around which monetary control of the banking system revolves is the cash position of the chartered banks. The requirements of each bank in respect of the management of its own cashposition provide the basis for central-bank regulation of the banking system as a whole. For any one bank, managing the cash position is a matter of keeping the cash on hand adjusted to the needs and wants of the bank for cash to hold. When the cash on hand exceeds what is required, taking into account everything that influences a bank to hold cash, the bank sets out to exchange the excess cash for earning assets, thus expanding its holdings of earning assets and also possibly its deposits. Similarly, when a bank concludes that it has too little cash relative to its requirements it sets out to acquire cash by disposing of earning assets, thus tending to contract its holdings of earning assets and also its deposits. Thus, whether at any moment of time the banking system will be tending to expand or contract its earning assets and its deposits, depends on the combined cash position of all the banks. For example, if the combined cash on hand exceeds the combined requirements of all the banks, the system will be trying to expand. Hence monetary control, in the sense of inducing the banking system to expand or contract, is a matter of the central bank altering the supply of cash to the banks relative to their requirements for cash.

21. The present method of fixing the reserve requirements in advance for the next reserve period has been criticized on a number of grounds. It has been pointed out that changes in the reserve base, and so in requirements, may at times be quite abrupt, requiring similarly abrupt intervention by the central

bank if it wishes to maintain the same degree of ease or tightness of reserves. It is also contended that the present method does not cause requirements to change fast enough when all banks are expanding simultaneously. In any one month the banks could expand in step and would face no restraint from a rise in requirements until the following month. It is asserted that tying bank reserve requirements to the latest deposit figures would make monetary policy more effective because any increase in deposits would bring an immediate deficiency in the cash position, and the banks would react as if the central bank had taken cash away from them.

22. As the requirements stand at present, however, the central bank can readily counter any unwanted expansion or contraction almost immediately by open-market sales or purchases of securities. If for example there is an expansion because the banks are adding to their holdings of marketable securities the central bank could offset it by selling securities. If on the other hand the banks are adding to their loans the effects will not show up in the open market, at least not immediately, but in the deposit liabilities of the banking system. If the central bank sees deposits rising when it would prefer them not to rise, it can withdraw cash from the banking system to counter the expansion.

23. Whether an automatic change in the cash position, caused by a rise in requirements, is to be preferred over a discretionary cash change, produced by the central bank selling securities when it sees bank deposits rising, depends primarily on whether the automatic cash change would occur faster than the discretionary change. If the central bank did not receive deposit figures until much later than do the individual chartered banks, there would clearly be merit in favouring automatic cash changes. Under Canadian conditions however deposit figures are available to the central bank almost as soon as they are to the

individual chartered banks.

24. Another criticism of the present formula for setting reserve requirements is the length of the averaging period, i.e. a calendar month, which is alleged to cause the banks to be sluggish in response to their daily cash position. Rapidity of response, however, also depends on the instruments available for adjusting bank cash and on the volume of transactions that the market in those instruments can handle. The shorter the reserve period the better the market has to be and the greater the variety of instruments required. A shorter period would make it more difficult for a bank to carry out its cash adjustment transactions in the money market. On the selling side it would have to bunch its transactions more, and on the buying side it might have to forego some transactions because of limitations. In other words, shortening the reserve period does not necessarily lead to faster responses.

25. If the averaging period were shortened, however, the present restrictions on chartered bank borrowing from the Bank of Canada should be eased, and indeed these restrictions merit review in any case. It is now the practice for the Bank of Canada to make advances against the hypothecation of suitable securities, and advances to each bank are normally limited to a specified amount somewhat resembling an established line of credit; these limits have not been changed in many years notwithstanding the substantial increase in banks' assets and liabilities. Each advance or renewal of an advance is made for a fixed period of seven days. The first advance in any calendar month up to the specified amount bears interest at the Bank Rate. However, a second advance to the same bank in any calendar month, or a renewal of an advance, or an advance in excess of the specified amount, bears interest at some unspecified higher rate and is subject to negotiation. These limitations interfere with the traditional role of the central bank as lender of last resort.

Moreover, a "Bank of Canada Funds" market would probably be a prerequisite for overcoming the difficulties that would ensue. A "Bank of Canada Funds" market, in which banks could sell their excess cash with the Bank of Canada to banks in need of cash, could be introduced, as in the New York money market where there is active trading in "Federal Funds". Whether such a market should be introduced even under the present method of calculating reserve requirements depends on the ultimate effect it would have on the money market. We are not opposed to such an innovation, but we believe that it would inhibit the development of the money market.

26. On balance we consider the advantages of fixing the cash reserve requirements in advance and averaging reserves over a calendar month outweigh the disadvantages. We recognize that in the public interest bank credit policies must conform to the requirements of monetary policy with reasonable promptness, but we feel that any proposed change should be clearly justified in advance, especially if it would add to the burdens that are imposed on the chartered banks and only on the chartered banks.

27. If reserve requirements are imposed on banks only, however, it is important for monetary control that they be not set too high. Reserve requirements imposed solely on the banks place the banks at a cost disadvantage relative to non-bank competitors, which of course encourages the growth of these competitors relative to the banks. As a result, the central bank has to restrict the size of the banking system to compensate for this additional growth in non-banks, and the effect is that the control base on which the central bank must act becomes smaller relative to the total financial system with the passage of time. In other words, reserve requirements applied to banks alone should be no higher than necessary so that the efficiency of monetary policy will be preserved

Investments

28. One of the primary functions of a chartered bank is to make loans. It follows that bank investment activities are normally subsidiary to bank lending activities. Since loans vary as a result of seasonal, cyclical, and irregular influences, a chartered bank must be able to adjust other earning assets up and down fairly readily in order to accommodate its borrowing customers; the investment portfolio permits this to be done while employing the residual funds profitably. On the deposit side, although the total deposits of an individual bank tend to remain relatively stable in relation to the banking system, the cash position can be sharply affected over short periods of time through temporary gains or losses in the net clearing of funds among the banks. In order to meet any conceivable cash withdrawal, large or small, on demand and without the slightest qualifications as to its immediate availability, a bank must have readily realizable investment assets in addition to cash itself.

29. Another reason for an investment portfolio is to give a balanced structure to the bank's assets, which is important for a flexible bank lending policy and for maintaining the confidence of the general public and of customers at home and abroad The weight of risk assets must be balanced by a proportion of relatively riskless assets, such as securities of the Government of Canada.

30. In the maintenance of their investment portfolios the banks do from time to time participate in the financing of federal, provincial, and municipal governments, and to a lesser extent of corporations. As national savings institutions, the banks share in the task of providing funds for the financing of both current and short-term capital requirements of all three levels of government. The federal budget is one of the most significant factors affecting the size and nature of chartered bank investment portfolios. During the Second World War huge budget deficits were

financed in part by the chartered banks. In the first seven years after the war some federal debt was retired, and the growth of the economy brought other potential lenders into the market, so that bank holdings of Government bonds were reduced. Since the mid-fifties, the re-appearance of sizeable Government deficits accompanied by more active monetary policies has led to a greater variability in bank holdings of Government securities.

31. Generally, the further away from cash an investment is, the higher the rate of interest it earns. Hence the management of a bank's investment portfolio usually consists of steering a judicious course between low-yielding "near-cash" assets and higher-yielding less-liquid assets. The most easily realizable assets are day-to-day loans, and Treasury bills issued by the Government of Canada, followed by short-term Government of Canada bonds. Ranked behind these assets, in terms of liquidity, are medium-term Canada's and provincial short-term bonds, longer-term Canada's and provincial bonds, municipal and corporate securities, mortgages, and other assets, but not necessarily in that precise order.

32. Short-run fluctuations in bank deposits and loans are met primarily by increases or decreases in "secondary reserves" - day-to-day loans and Treasury bills. Longer-term movements in security holdings are likely to be related to cyclical influences. An upsurge of business generally brings with it a rise in business inventories, an expansion of working capital requirements, and a general drain on the liquid assets of bank customers which causes them to employ more fully their existing lines of credit at the banks or to seek larger lines. The use of monetary restraint in recent periods of strong business activity has meant that at such times the chartered banks have been able to meet increasing customer demands for loans only by selling securities. The process of liquidating securities when the money supply had not been permitted to increase was a factor in a fall in bond prices and a rise in interest rates which spread from short-term securities

into medium-term and longer-term bonds.

33. When business is deteriorating, the demand for bank credit and competing forms of credit by the private sector of the economy tends to decline. In recent years the federal government has employed the counter-cyclical device of deficit financing and called upon the banks, directly or indirectly, to take up sizeable new issues of securities, usually with the support of the central bank, which has provided the banks with sufficient reserves to support large-scale buying. Easy monetary conditions imply relatively low rates of interest, so that the banks have often found themselves buying bonds at high prices, knowing that later on they might have to sell at lower prices in order to accommodate their customers when conditions changed and money became tight. The only way out of this dilemma has been to hold a substantial volume of securities maturing within a short time. Of course this means sacrificing yield for liquidity, so that because of their key role in implementing monetary policy the banks as investors are at a disadvantage relative to other institutions. Experience since the mid-fifties shows that the banks have learned that, given massive Government counter-cyclical fiscal policies and widely varying monetary conditions, their investment portfolios must be shorter than was the case formerly, and that more thought has to be given to anticipating changes in business conditions.

34. How far can the process of selling securities go before a bank feels that its liquidity is at a minimum level? This depends on several factors, which are: the extent of the rise in yields and the concurrent fall in prices and hence the cost of liquidating securities, the anticipated borrowing needs of customers, the size of the portfolio of securities and the speed with which it is being reduced, the attitude of the monetary authorities, and finally expectations regarding all these factors. Experience in the two periods of extreme monetary tightness which occurred in

the 1950's suggests that although standards in this respect may change from time to time the banks' portfolios of Government securities at any given period are reducible only within limits, beyond which the banks regard them as essential to the general safety of deposits.

Lending

35. Bank lending policy is formulated by the management of each bank, taking into account market conditions, general economic trends, and changes in monetary policy. Lending policy may be revised, for example, if weakness appears to be developing in a particular industry. Policy changes of this kind reflect the continuous assessment of credit risks which is a part of the process of banking. In addition, however, as the business cycle moves from one stage to another, changes in official monetary policy will produce corresponding changes in the lending policy of the chartered banks. If this latter process is to work smoothly it is necessary that official policies be adequately signalled and clearly understood.

36. Bank lending policy is applied by issuing instructions to credit supervisors at the head office, to the various regional offices, and to branch managers across the country. In this connection it may be noted that the period since 1955 has been the first for a generation in which the branch system has had to adjust to a changing monetary policy. Moreover, on occasion the somewhat obscure nature of monetary policies has made it difficult to determine appropriate lending policies.

37. Other practical problems in adjusting lending policies to changing economic conditions arise because of the difficulty of assessing the meaning of changes in the demand for bank loans in relation to the business cycle: bank loans may rise because business is improving, or because inventories are being acquired ahead of a real improvement in business, or because sales are falling off and stocks are building up involuntarily. Another

problem is that adjustments in bank lending policies, apart from changes in interest rates, take effect primarily through alterations in lines of credit, and thus take some time to have their full effect; it is not possible to review all existing loan commitments at once, and it is difficult for the banks to anticipate the take-up of unused lines of credit. More generally there are difficulties in restraining lending because of the natural tendency of commercial bankers to make good loans whenever possible. The training of branch managers is, after all, aimed at the development of officers who can seek out lending opportunities and make good loans, and the advancement of these officers depends to a significant degree on their ability in making loans.

38. It should be remembered that the Canadian branch banking system has an important degree of built-in flexibility, because behind each branch stand the resources of a large nation-wide institution. This means that, subject to the general availability of funds, each borrower may be dealt with on his own merits without being limited by the position of his local bank branch.

39. The allocation of credit in periods of monetary restraint has become increasingly difficult since the mid-fifties because the general structure of interest rates in the economy has been relatively high and the prime loan rate has been driven very close to the ceiling. The banks have been forced into a rigid pattern of rates under which almost all borrowers pay much the same rate on loans and the banks are unable to use flexible rates as one of the methods of allocating credit.

40. In the absence of flexible interest rates the problem of allocating bank credit when money is tight becomes one of rationing. When credit is scarce the banks do not usually establish special restrictive policies regarding loans to particular industries, and never do so in respect of loans in particular regions.

Certain types of loans are usually curtailed as less essential, such as term loans for projects which could be financed outside the banks, loans to buy securities or real estate for speculative purposes. Loans to other credit-granting institutions are also restricted when money is tight. In the main, however, the process of rationing credit involves reviewing each individual loan account on its merits. It cannot be emphasized too strongly that having to implement a tight-money policy by placing restrictions on individual borrowers, having to choose among equally creditworthy customers, and having in effect to decide which projects may go forward and which may be stopped by lack of funds is a difficult and disagreeable task but one which in the boom phase of the economy sometimes becomes necessary in order to conform with current monetary policy.

41. In the first instance a bank will usually restrict borrowing which appears to be non-essential. When a customer's balance sheet isexamined it may appear that the line of credit which has been asked for is high relative to the size of the business. This may be because the borrower is trying to protect himself against tight-money conditions which he fears may arise in the future, or is asking for a larger line of credit for prestige reasons, or is carrying inventories which are too large relative to sales. In such cases the bank will probably tell the customer it considers that he is asking for more money than he needs.

42. Credit is not rationed on the basis of size of account. The banks have always assumed that their primary responsibility was towards their smaller business customers. The subject of loans to small borrowers has been reviewed with the Bank of Canada on various occasions since 1955 when the first tight-money period began. The withdrawal of the banks from the term-loan field of lending did not apply in the area of small business, and every effort has been made to meet the needs of those borrowers

whose size does not enable them to obtain funds by issuing securities.

43. The banks have recently carried out four surveys of loan accounts classified both by industry and by size. The most recent analysis, at September 1961, covers a total of $5,830 millions of loans. Of this amount 32% was in accounts of under-$10,000, and 52% was in the accounts of under $100,000. Classified by number, 96.6% of all borrowers were in the under-$10,000 category and only 0.54% had accounts of $100,000 or more. The proportion of total loans made available to smaller borrowers has risen slightly with each survey.

44. It must be realized, however, that in times of extreme credit stringency the banks will be obliged to curtail loans for the purpose of carrying securities or for speculative purposes, and small borrowers in these categories will be affected in the same way as the larger ones, the prime objective being that of conserving lending resources for basic needs.

45. Apart from wartime emergency regulations direct controls on bank lending have not been used very much in Canada, and the banks are not in favour of such controls whether imposed by the central bank or by the Government. We believe that any form of selective controls on bank lending would reduce the flexibility of the Canadian banking system, which has been one of the strongest factors in the growth of the economy, and could not fail to result in injustices to specific sectors of the economy.

46. One of the most distinctive features of bank lending in Canada, which goes right back to the 19th Century, is the legislation which allows a chartered bank to make advances on the security of natural products and goods, wares, and merchandise while they remain in the borrower's possession. This is Section 88 of the Bank Act. Similarly, Section 86 of the Act provides that a bank may lend on the security of a warehouse receipt, and Section 82 makes provision for banks to make advances to oil

operators on the security of hydrocarbons in, under, or upon the ground. All these sections were designed to encourage the development of Canadian resources by enabling producers, certain wholesalers, and manufacturers to borrow more than they otherwise could to meet the essential financial needs of their business pursuits. Parliamentary records show that the same motive was behind subsequent steps in the development of this feature in the banking system. These sections of the Bank Act are a means of providing support in many fields of endeavour to an extent which otherwise would not be practical from the standpoint of prudent banking. This applies particularly to agriculture and what may be termed smaller business enterprise with limited financial resources, and often to business enterprises at an early stage in their development, before they have sufficient resources to qualify them for bank credit in the ordinary way.

47. A recent survey suggests that loans outstanding under these sections of the Bank Act amount to something over $1 billion, or 18% of total general bank loans. Although, because of the fact that there is often more than one type of security behind a given loan account, it is impossible to say what proportion of the loans could not have been made without the use of this legislation, it is likely that most of these borrowers would not have been able to borrow, or would have borrowed at higher rates from other institutional lenders. We believe that these sections of the Bank Act are making an important contribution to Canada's financial system.

48. Because the banks already have well-developed facilities they are able to offer consumer credit at rates which (including service charges) are more favourable to the borrower than those charged by specialized institutions. In general, the banks have set up these programs to reach a group of borrowers who, while unable to provide collateral in the traditional form,

are nevertheless creditworthy, and who wish to borrow for worthwhile purposes usually connected with their homes and families. We believe that consumer instalment credit has become firmly established and that such loans are a logical development of banking services. The extensive branch bank system is highly suitable for providing consumer credit.

49. Mortgage lending is a field from which Canadian chartered banks were barred until 1954 when the banks were permitted to enter the NHA field. In the period from then to 1959 the banks accounted for about 35% of all NHA loans made. In December 1959, however, the maximum NHA rate permitted was raised by the Government to 6-3/4% and, although banks could still process NHA mortgages, counsel's opinion was that they could not do so at a higher rate than 6% because of the legal ceiling on bank lending rates. The result was virtual cessation of NHA lending by the banks, since if they had made mortgage money available at 6% while all other lenders were charging 6-3/4% the banks would have been faced with very large demands for funds and an impossible task of credit rationing. We believe that the legislation should be adjusted to permit the banks to participate in NHA mortgage lending on a continuous basis, at whatever may be the going rate of interest for such loans.

50. We believe that the powers of the banks should be broadened to allow them to lend on mortgage security generally. This would extend the range of customer services and would fit in with the Government's desire to see more mortgage lending on the part of private institutions. The history of banking shows that some proportion of deposit funds may safely be made available for long-term investment. Also the banks have suitable administrative facilities for making mortgage loans across the country, as well as specialized mortgage departments set up at their head offices to handle NHA mortgages. It is further argued that a number of recent Acts of Parliament, especially the Small

Businesses Loans Act, have had to make special provision to allow banks to take mortgage security in certain cases. In the conduct of ordinary banking business there are also many occasions where being able to take mortgage security as collateral would make the difference between assisting or refusing a customer.

51. In a related context the powers of the banks to take specific security in the course of lending operations appear to be unduly limited in the light of present-day requirements. For example, the power of the banks to take chattel mortgage security is limited to loans made to an individual on the security of household property (as defined in the Bank Act), with the result that the banks are prohibited from taking such security either on a wider range of goods or in respect of manufacturers' and dealers' inventories. We recommend that the whole matter of existing limitations on the nature of specific security available to the banks should be reviewed with a view to leaving the banks as free as possible to take such security as the requirements of individual situations might indicate. The result would, we suggest, be an appreciable and useful broadening of the banks' ability to serve the increasingly complex and changing requirements of the business community.

52. An important aspect of the lending activities of the chartered banks is the financing of Canada's external trade. Besides providing the foreign exchange machinery whereby importers pay their foreign suppliers and exporters receive payment from their foreign customers, the banks provide credit facilities for financing the transactions. In the case of exports this may cover the full period from domestic production operations to final settlement from abroad; in the case of imports it may encompass the time between the signing of a contract to purchase foreign goods and the final sale to the ultimate buyer. For longer-term financing, one to five years, the banks have established the Export Finance Corporation of Canada, Ltd., to assist Canadian ex-

porters in meeting the credit terms offered by foreign competitors. This corporation is in fact a "rediscount bank" to which the chartered banks turn over foreign trade obligations discounted by them for Canadian traders.

53. In order to broaden and improve the facilities and operations of the money market in Canada the chartered banks have given very careful study to the creation of a market in bankers' acceptances. A detailed study of the techniques and procedures which relate to the bankers' acceptances market in both the United Kingdom and the United States led to the conclusion that neither system could, without considerable variation, readily be adapted to Canadian conditions. As a result bankers' acceptances in Canada will not follow either the New York or the London pattern. As far as possible bankers' acceptances will be drawn in connection with the financing of goods, wares and merchandise of a type described in Sections 18 (1) (f) and (g) of the Bank of Canada Act; will be in large denominations and will be of a self-liquidating nature. It is as yet too early to determine the extent to which Canadian firms will find bankers' acceptances a convenient and suitable medium.

54. The money market dealers will act as principals to purchase and sell bankers' acceptances for their clients. The function of the chartered banks will be to assess the credit worthiness of the drawer of the acceptance draft and, if his is the primest credit, to accept such a draft and return it to the drawer. It is the drawer's responsibility to sell the accepted draft to a money market dealer. Bankers' acceptances will be eligible collateral as security for day-to-day loans in the money market and under Section 18 (1) (b) of the Bank of Canada Act the Bank of Canada has indicated its willingness to deal in bankers' acceptances which have a term to maturity of not more than 90 days. During the initial stages of the development of the acceptance market the chartered banks, in order to assess the usefulness of

this new instrument in the market place outside the banking system, will not themselves purchase acceptances for their own account. It has also been agreed that, after a period of six months from the beginning of the market in bankers' acceptances, the chartered banks will review the experience gained in that interval and make such changes in techniques and procedures as in the light of this experience are necessary or desirable.

Deposits

55. Public attention is, perhaps, most often focused on the lending and investing aspects of banking. But the ability of the chartered banks to carry out their lending functions adequately depends on the way in which the banks perform, or are permitted to perform, as deposit institutions. Chartered bank deposits fall into two major classifications, demand deposits and notice deposits, in proportions which have varied over time. Notice deposits amounted to roughly two-thirds of total Canadian deposits in 1930 and 1935. By 1945 they had fallen to under 50%, but have since risen to about 60% of the total.

56. Besides the deposits of corporations and individuals, "demand deposits" include those of governments and other banks. They perform two closely related functions in the economy, that of a store of liquid value, and that of the chief medium of payment in Canada. The volume of payments made by cheques on current accounts in the chartered banks has increased much more rapidly than the level of the deposits themselves. In the post-war period, the annual turnover or velocity of demand deposits has increased from 24 times in 1945 to over 68 times in 1961. This increase has not only posed problems for the banks in the operating procedures needed to handle the heavier flow of cheques, but also presented a problem to the community in the exercising of monetary policy, resulting in the need for more vigorous central bank action.

57. The growth of demand deposits since 1935 has not kept

pace with the rise in Gross National Product, nor has it followed a steady pattern from year to year. Rather, in response to central bank action, demand deposit growth has tended to follow a counter-cyclical pattern, particularly in the post-war period.

58. While demand deposits represent, in general, the "working capital" of individuals, organizations, and companies, notice deposits are more likely to represent their reserves held pending a major expenditure or with investment in view, as a cushion in case of emergency, or simply the accumulation of savings built up over the years. The chartered banks have long been the most important savings institutions in Canada and, at latest count on September 30, 1961, they had over 10.8 million personal savings accounts on their books. While the total of such deposits has increased faster than demand deposits in the post-war period, their growth, like that of demand deposits, has tended to follow a counter-cyclical pattern. Much of the growth of savings deposits has been encouraged by the rapid increase in the number of branches operated by the chartered banks, which has enabled them to reach a wider proportion of the population. However, the growth of savings deposits has not kept pace with the rise of G.N.P. in Canada. This is a reflection, not of a lower propensity to save on the part of Canadians, but rather of the growing importance of other savings institutions.

59. To meet the competition for the surplus funds of corporations and institutions the banks in recent years have issued deposit receipts for funds left for fixed periods of up to one year, and one of the banks now issues negotiable term notes with maturities of up to six years. While they are used principally by corporations and institutions, these deposit receipts and term notes are also available to individuals and executors or trustees of estates.

60. The turnover of savings and other notice deposits is

much lower than that of demand deposits. In view of the greater stability and lower velocity of notice deposits, suggestions have been made from time to time that the chartered banks might quite properly engage in a much larger way in longer-term financing. However, from the community's point of view the over-all problem is to achieve a balance in the total supply and demand for financial resources. It has been the function of financial organizations, especially the banks, to receive the savings and working capital of the community for varying terms and to apportion them as loans or investments at short or long term as circumstances warrant. We are opposed to any attempt to segregate deposits by term or type because the result would be to introduce undesirable rigidities into the financial system.

Foreign Currency Business

61. Canadian chartered banks provide a full range of international banking services, including the maintenance by some banks of branches, agencies, and representative offices abroad. This is a natural corollary of the great importance to Canada of international trade. If Canadian banks were not able to provide the whole range of banking services necessary for carrying on an extensive import and export business, Canadians requiring these services would have to obtain them from foreign bankers. Canadian banks are able not only to meet Canadian needs in this respect, but also to compete successfully with foreign banks for additional international business. The provision of international banking services is a field in which there is intense competition and it is essential that Canadian banks have great flexibility in their foreign operations in order to be able to meet such competition. The success of Canadian banks in this area of activity means an important net contribution to the credit side of Canada's balance of payments. The foreign currency business of banks arises out of transactions with foreign countries including imports, exports, investment, payment for services,

tourism, and remittances of all kinds. The operations involve all types of transfers, cheques, drafts, currencies, bills of exchange, and commercial letters of credit. The banks in Canada are also active in the forward markets for the key currencies, U.S. dollars and sterling, and for all the other free currencies in which there is forward trading.

62. In recent years substantial deposit and lending markets have developed for U.S. dollars and sterling outside their countries of origin. These types of deposits and loans are commonly referred to as Euro-dollars and Euro-sterling. In addition to the normal requirements of importers and exporters and other customers requiring foreign deposits, such factors as differential interest rates and anticipations regarding the exchange rate have contributed to the development of these markets. Canadian banks have entered actively into this highly competitive area of banking, particularly with respect to U.S. dollar deposits. Such deposits do not of course leave the United States but remain within that country for use there. The growth of such deposits has not of course been confined to Canadian banks, since institutions in other countries have been competing aggressively for these deposits. It should also be noted that Canadian funds may flow into foreign banks in the same way, depending on interest rates and anticipations regarding the exchange rate. In general deposit liabilities are offset by assets in the same currency, hence the risk of an exchange position is avoided. In short, this is a field of international operations where there is intense competition and where Canadian banks have had considerable success. It is, however, an area where deposit and lending rates are quoted at very narrow spreads, allowing little margin for losses, commissions, and the costs related to reserves. Any restrictions on Canadian operations in this field would increase costs and give a decisive competitive advantage to non-Canadian banks.

Banks in the Securities Business

63. Chartered banks make an important contribution to the capital financing of major new projects in Canada through their participation in syndicates set up to handle the underwriting and distribution of securities. They usually provide the preliminary short-term financing and are in a key position to assist in making the transition to long-term financing. They work closely with investment dealers in endeavouring to ensure that capital issues are properly designed, taking into account the interests of both sellers and buyers. With their widespread network of branches banks are particularly well placed to assist in the distribution of securities across Canada, and they have made it a point to ensure that their customers in all parts of the country have an equal opportunity to obtain a share of new issues, insofar as the banks' participation in such issues will permit.

Revenues and Expenses

64. The revenues of the chartered banks are derived principally from two main sources: from interest on the use of their financial assets - loans, securities, etc. - and from charges made to customers for services rendered. The latter source has declined in relative importance in the post-war period because rate schedules have remained largely unchanged and increases in such revenue have depended principally, therefore, upon the growing volume handled. From the other source of earnings - interest on financial assets - there have been increases in both rates and total volume. In addition, during the post-war period loans have grown at a greater rate than investments; while investments exceeded loans in 1945, the position now is reversed. Loans generally earn higher rates than investments, so the relatively greater expansion of loans has contributed to the improvement in earnings.

65. The most significant increase in bank costs in point of size has been the rise in interest expense. This has resulted

from the expanded deposit base, from a shift from non-interest bearing deposits into interest-bearing, and from a considerable increase in rates paid on deposit balances. Other items of expense including salaries have also risen, but remain in about the same proportion to each other.

66. The result of these trends in bank revenues and expenses has been a considerable increase in net earnings in the post-war period. However, it appears unlikely that the chartered banks will be able to increase the rate of return on total assets much above present levels. The post-war shift from low-yielding securities to higher yielding loans, however, seems to be approaching an end with the ratio of risk assets to deposits near 70%. At the same time the shift from non-interest-bearing to interest-bearing deposits has shown no sign of slowing down.

Capital

67. The capital funds of a bank are used to supply the physical means of doing business, to ensure the protection of depositors' funds, and to enable the banks to engage in international operations. While capital has grown in absolute amount, the proportion of capital in relation to deposits or to risk assets is considerably less than it was 30 years ago. Not only has there been a large increase in bank holdings of Government bonds and in Government-guaranteed loans, but also the operations of the central bank in providing liquidity have reduced the relative need for capital compared to that maintained in the 1920's and 1930's. This trend, of course, is not restricted to Canada and is evident also in both the United States and the United Kingdom.

68. The banks at present have some 85,000 shareholders. This is an increase of 50,000 since 1944 when, in accordance with the Bank Act revision of that year, stocks were split ten for one. It seems to us desirable that widespread ownership of shares in the banks should be encouraged, and the price of each share should not be so high that small investors find them inconvenient to buy. We therefore recommend that the shares should be sub-divided again

Inner Reserves

69. Basically the inner reserves of the chartered banks are a cushion against the contingencies of the future. Their size, however, is currently governed by a formula which uses the average loss experience for the past 25 years. It thus produces the anomalous result that good years push the allowable percentage down at the very time when reserves should be built up, and conversely a period of high loss experience permits a higher allowable percentage when reserves are actually being depleted. It is the opinion of the banks, therefore, that the present formula should be supplemented by a specified "floor", which would prevent the ratio from falling below an adequate level.

70. The important function of inner reserves is to provide out of current earnings for unforeseen banking losses that are almost sure to be incurred in future years. As explained very clearly by the Ministers of Finance during both the 1944 and 1954 Bank Act Revisions the chartered banks depend more than any other institution on the confidence of their depositors. At the same time they are expected to take the risks inherent in carrying on a lending function. They can carry out this function most effectively if their management feel they can absorb the unusually high losses that occur in some years without losing the confidence of their depositors.

71. As for the non-disclosure of inner reserves it can be said that in banking the interests of depositors are paramount. The reputation for stability of the Canadian chartered banks is a national asset of the first importance to the community in general, and it is certainly not in the public interest to endanger this reputation either at home or abroad.

72. The history of the years after 1929 demonstrates the public advantage of the banks being able to present a reasonably stable position in a time of violent and sudden stress, and it seems to us desirable therefore that the banks should be permitted to maintain a buffer of undisclosed reserves.

FINANCIAL COMPETITION AND CONTROL

Competition Among Banks

73. Competition from other lenders and other deposit institutions keeps bank deposit and loan rates and other charges closely in line with the overall structure of competitive rates, though there is some scope for variation because bank loan and deposit facilities are associated with other banking services that must be paid for in one way or another. Among the chartered banks themselves however competition must take a different form. The various banks offer a virtually identical range of services to the public, and no one bank has a monopoly of staff and facilities capable of performing these services in a courteous and efficient manner. It is obvious that any bank will have to meet the best rate offered by other banks in any major category of service, otherwise it will lose virtually all of its business in that line; there is therefore little scope for differences between banks in respect of interest rates or charges. For example, if the interest rate structure is considered unbalanced, there may be some question as to whether it is lending rates or deposit rates that should be changed. Almost invariably the bank which is willing to operate at the rate most favourable to its customers sets the pattern for all the others; no one bank or group of banks could long continue to exact terms less favourable than any one bank or minority of banks was prepared to offer.

74. Banks compete vigorously for both lending business and deposit business, where much depends on personal relationships and personal judgment. They compete in attracting new enterprises, both domestic and foreign, and assist newly established businesses in a number of ways. Specialized knowledge of and service to particular industries are other forms of competition, and include the provision of information to customers in various forms.

75. The provision of a network of well-located branches is undoubtedly one of the major forms of competition among banks. A wide and efficiently distributed network of banking offices has always been essential to any banking system in rendering service to its customers, and never more so than today. Branch banking as it has developed in Canada has shown itself capable of meeting this need admirably. It brings the full range of banking services to the newest community without delay. It has also been successful in meeting the demands of the dispersal of population and industries around the peripheries of major cities, and the development of new industrial areas. This phenomenon is perhaps less spectacular than the enlargement of our geographic frontiers, but it is a pervasive movement that is affecting a much larger proportion of all bank customers.

76. The decision to open a new branch in a given location is based on a variety of considerations. It must fit in with the needs of a balanced geographic distribution of branches across the country. The prospects for business growth in the general area to be served must be carefully examined. The particular site must be convenient to existing and prospective customers. The number and location of branches of other banks near by and of other branches of the same bank must be considered, for there is no profit in entering an area that is already over-banked no matter how promising it is in other respects. No branch is expected to be profitable from the start, though this does happen in exceptional cases. Generally speaking, however, a new branch is expected to begin earning a profit within three to five years.

Entry into the Banking Business

77. Traditionally in Canada entry into the banking business has been carefully regulated under the Bank Act in the interests of ensuring a sound and reliable system. In earlier days the statutory provisions with respect to minimum capital requirements and the scrutiny of the authorities were doubtless the major obstacles

to be overcome. Nowadays, however, even if a group wishing to found a bank had little trouble raising the minimum capital required and assuring the authorities of their good faith, they would find it difficult indeed to win a sizeable share of the Canadian banking business unless they could rapidly build up a trained staff and a wide network of branches. The amount of capital and the organizational work involved in so doing are surely a far more powerful deterrent than the statutory requirements.

78. If we look no further than the performance of banks chartered under the Bank Act, there seems to be little justification for modifying the provisions that now apply to entry into the banking business. The need for sound and responsible banking practice is more pressing, not less, in a complex modern society. Many of the techniques devised in other countries to improve and strengthen their banking systems have been in large part to achieve what was already characteristic of Canadian banking; others have already been adopted in Canada; none of them offers any reason for reversing the traditional pattern of our banking legislation. By any objective comparison with other countries, Canadian banking must be rated highly.

79. However, if we broaden our view to take in the performance of banking and quasi-banking functions by other financial institutions, a somewhat different picture emerges. Experience over the years has led to the imposition of stringent controls over the chartered banks to ensure that they are soundly operated and that depositors' funds will remain liquid in times of financial crises -- special provisions concerning shareholders' audit, rigid internal inspection, and supervision by the Inspector General of Banks; the detailed provisions of the Bank Act in relation to formation, management, and winding up; limitations on the activities in which banks may engage; and so on. This provides a formidable armoury of safeguards under federal legislation.

To a somewhat similar extent the same situation, in respect of legislative safeguards, applies in the case of the two institutions operating under the Quebec Savings Bank Act, a federal enactment broadly modelled on the Bank Act. Yet many other financial institutions now hold large portions of the liquid savings of the public under conditions not greatly different from those which applied to banks in the days before the development of modern safeguards to protect the depositor. It may even be that the very success of the measures for assuring strong and sound banks has lulled the authorities and the public alike to the dangers of unregulated banking. Our forefathers had intimate practical experience with these dangers, but this generation has not. In any case the tradition of safety built up by the chartered banks has made it easier for the near-banks to grow without actually having to provide to the public the financial protection that is nowadays taken for granted.

Competition with other Financial Institutions

80. The Role of the Chartered Banks. The Canadian chartered banks have traditionally been the chief depositories for personal savings and have also been the chief source for most kinds of short-term business financing and personal loans. In addition, they have long played an important role in government financing as purchasers of Government of Canada securities, and more recently they have provided a foundation for the growing Canadian money market, which depends in a substantial degree on the fact that the chartered banks keep a secondary reserve in the form of day-to-day loans to money market dealers and Government of Canada Treasury bills. Under the National Housing Act, until the going rate of interest went above the maximum permitted the banks, they made a substantial contribution to residential mortgage financing, a field otherwise prohibited by the Bank Act. Since the establishment of the Bank of Canada, monetary policy has also been implemented primarily through the effects on

chartered bank operations of variations in bank cash permitted the chartered banks by the Bank of Canada. The operations of the chartered banks are also regulated in detail by the terms of the Bank Act, as well as by certain of the terms of the Bank of Canada Act. Among the key points of these controls are the statutory limitation of 6% in the rate which may be charged for bank loans, the statutory requirement to hold 8% cash against Canadian deposit liabilities, together with the supplementary agreement on secondary reserves, and the prohibition under the Bank Act of acquisition by the chartered banks of certain types of assets, notably conventional mortgages.

81. Development of Other Financial Institutions. Over the years a considerable number and variety of other financial institutions have developed in Canada in competition with the banks. Although none of these other institutions offers a full range of banking services, each of them has taken on some functions and services of an essentially banking nature. To the extent that these other institutions may have developed by providing services and facilities which for one reason or another the chartered banks did not provide, the result may be regarded as a desirable growth in the range and flexibility of financial services in Canada, although it has also produced problems in the field of monetary policy for which solutions are needed. However, to a very considerable extent, these competing institutions have made such rapid headway in circumstances in which the chartered banks were prevented by legal or other rigidities from competing effectively. It might also be pointed out that some of these institutions enjoy freedom from income taxation.

82. The major functions of a banking nature performed by these other institutions are primarily the acceptance of savings and other deposits in various forms from the community; the extending of loans for a wide variety of purposes; the provision of the equivalent of chequing services, made possible in practice

by access to the chartered banks' clearing system; and the provision of safety deposit boxes and other safekeeping services. These functions are performed without the limitations enforced on the chartered banks by the Bank Act, the Bank of Canada Act, and certain "agreed" arrangements with the Government and the Bank of Canada. "Banking" is not defined in our legislation and various possible definitions, from the point of view of economic analysis, are in varying degrees inadequate or misleading. However, from the point of view of monetary policy these institutions are important instruments for the expansion of credit in the economy and, as such, their operations directly affect the success or failure of monetary policies even though they are not, like the chartered banks, directly amenable to control in the interests of official monetary policy.

83. Among these competing institutions are credit unions and caisses populaires, finance companies, small loan companies factoring companies, trust and mortgage loan companies, Quebec savings banks, provincial government savings offices, and the Post Office Savings Bank. These institutions are all competing actively for the savings or loanable funds of the community, and many have greater freedom than do chartered banks in the way in which they can invest such savings and other funds, and therefore in the returns which they can pay to lenders and depositors. Government of Canada Savings Bonds are also a very important savings instrument involved in the general competition for the community's savings.

84. Competition for Savings. Competition for the liquid resources of the community has intensified in the post-war years. The chartered banks' share over this period has declined from 87% of the given total in 1947 to 74% in 1960. This continuing relative decline is of importance to the chartered banks, and may have serious repercussions on the economy. If this trend had been the result of free and unrestricted competition among

the financial institutions involved, the public interest would have been served. This has not been the case, however, as the banks do not enjoy the same freedom as their competitors. The expansion of total chartered bank deposits is regulated directly by the central bank in the interests of counter-cyclical monetary policy. No such direct influence is exercised over deposits in competing institutions. Indeed, during recent periods of monetary restraint, when chartered bank deposits were being held down by central bank action, total deposits in the near-banks continued to expand rapidly. For instance, during the two years 1959 and 1960, while chartered bank deposits rose 1.8%, deposits etc. in Quebec savings banks, credit unions, government savings institutions, trust and loan companies, mortgage companies, and finance companies, rose 27%. (Investment by the public in Canada Savings Bonds rose by 24% in the same two-year period The banks are at a disadvantage in attracting deposits because of limitations on their ability to pay rates of interest on deposits comparable to those paid by near-banks.

85. Implications for Monetary Policy. Under present conditions, as competing forms of financial claims grow relative to chartered bank deposits, monetary policy has either to become more broadly directed against the total supply of liquidity or progressively more vigorous on chartered bank deposits in order to bring about a given expansion or contraction of total money expenditure. When monetary policy is restrictive heavy pressure is placed upon the banks which is not shared by other financial intermediaries. Consequently, under these conditions the near-banks can and do expand at a time when the chartered banks are required to restrict their growth. It follows, under these circumstances, that the central bank is forced to be even more restrictive as the chartered banks' relative position declines.

86. <u>Discriminatory Restrictions on Chartered Banks</u>. Each of the limitations of a discriminatory nature on the activities of the chartered banks has an inhibiting effect on the competition the chartered banks are able to offer these other financial institutions. Each of these limitations, therefore, contributes to reducing the sources of financing available to the Canadian public.

87. The 6% legal maximum interest rate is perhaps the most important. This ceiling may once have reflected public attitudes that were more understandable in the past, but in present circumstances it is difficult to find a rational explanation for it. A very large volume of bank lending is, in any case, done at rates lower than the legal maximum. This indicates that banks, like other financial institutions, must meet the going rates in each of many areas of financing. The rates charged reflect the nature of the risk, the costs of doing the business, and other relevant factors, including the vigorous competition of other banks and other institutions. In some areas of financing the going rates are often above 6%. These rates too reflect such factors as risks and costs but it is quite conceivable that they are in fact higher than they might be if chartered banks were allowed to compete at rates which would give them a fair return but which might well be less than is now charged by lenders shielded from such competition. Chartered banks would also, of course, be in a position to pass on to their depositors an appropriate share of any benefits resulting therefrom.

88. While the ceiling on bank lending rates has remained at 6% since 1944 other institutions, including the Industrial Development Bank as well as mortgage institutions and caisses populaires, are all charging more than 6% on loans at the present time. Although the cost of borrowing money from the banks is normally very small in relation to the total costs of doing business the cost of long-term funds from other sources for such projects

as utilities and pipelines is a decisive element in the total cost and often determines whether or not the project can be carried out. Yet there is a price ceiling on the first category of lending, and an open market without any legal limitation for the second category.

89. The practical impact of the 6% ceiling on bank lending rates was demonstrated most acutely in the summer of 1959. As the Treasury bill rate rose towards 6% it became theoretically possible for bank customers to borrow at the prime rate and invest the funds in other short-term securities at a profit while the banks were liquidating these very securities in order to make loans. At the same time large business customers who had been raising funds for short-term working capital from non-financial institutions while market rates were lower than the rates charged by the banks, suddenly found that the prime rate of the chartered banks was lower than the cost of alternative accommodation. Some of these customers proceeded to draw down bank lines of credit which had not been used for months or years, so that the banks found themselves with a sharp increase in the demand for business loans at the same time that the demand for other kinds of credit was also extremely strong. The 6% ceiling in this case not only prevented the banks from using the traditional device of raising prices to moderate demand but actually intensified the demand itself.

90. The interest rate rigidity has also had a profound effect on what has traditionally been one of the main features of the operations of Canadian chartered banks, i.e., the attraction of savings deposits. In the last ten years the rate of growth of savings in a variety of competing institutions has been much greater than in the chartered banks. The chief reason has been that these other institutions, since they are able to invest a very substantial proportion of their total assets in higher-yielding investments, notably conventional mortgages, are likewise in a

position to pay a higher return on savings obtained from the public. This results in a progressive limitation on the resources available to the chartered banks for lending and investment activities, and in fact makes it possible for funds to be attracted to depositories not always subject to appropriate safeguards.

91. It is sometimes argued that, provided these other institutions continue to maintain their cash balances in the chartered banks, the only result of this shift of savings deposits is a change in the ownership of the deposits in the chartered banks - with deposits from trust companies, etc., replacing those of individual owners of savings deposits - and that the cash reserves of the chartered banks are in any case regulated by the activities of the Bank of Canada, so that there is no necessary reduction in the lending and investing capacity of the chartered banks as a result of this drain of savings to other institutions. In fact, of course, the decisions of the central bank authorities as to the cash reserves to be allowed the chartered banks, and hence the decision as to the amount of financing the chartered banks are to be allowed to do at any time, must take into account the volume of financing being done outside the banks. If free competition were established between the banks and the other institutions, and if as a result the banks began to attract a growing share of savings deposits, and were in a position to compete for a share of the higher-yielding investments now taken by these other institutions, the decisions of the central bank as to chartered bank cash would undoubtedly take into account the larger requirements of the chartered banks. There is, in short, no way of avoiding the fact that the loss of deposits to competing institutions affects the chartered banks in exactly the same way as the loss of business affects any other commercial institution.

92. The primary and secondary reserve requirements, imposed only on the chartered banks, amounting in total to 15

per cent of deposit liabilities, are a further important limitation on the freedom of action of the chartered banks in their efforts to make the most effective use of their resources in competition with other financial institutions. Cash reserves, as a minimum percentage of deposit liabilities, were originally intended as a safeguard to the depositors, i.e. to the general public. With the present structure of inspection and supervision, both by the banks themselves and by the Inspector-General of Banks, appointed by the Federal Government, this is no longer the main purpose of cash reserves. The normal working requirements of the banks would dictate some level of cash reserves whether or not any legal requirement existed. The 8% legal cash ratio, however, introduces a rigidity not faced by competing institutions. A further rigidity is introduced by the undertaking to hold secondary reserves in the form of Treasury bills and day-to-day loans to money market dealers in amounts such that these assets together with cash are equal to 15% of deposit liabilities. This is not in a true sense a reserve, since it is not available for use; rather is it a forced investment. Thus, regardless of alternative investment opportunities which may well be more attractive at any particular time, the chartered banks are under the obligation to maintain substantial holdings of normally low-yielding assets. The consequence of these arrangements is that the chartered banks, alone among financial institutions, must pay a substantial direct cost, in the form of lower returns on their assets than would otherwise be available, as part of the current arrangements for implementing the Government's monetary policy and to facilitate, through the money market, the implementation of the Government's fiscal policy.

93. These reserve requirements are a basic element in a further restriction on the ability of the chartered banks to compete effectively with other institutions, namely the fact that

monetary policy in Canada is implemented by actions which bear directly on the cash position, and hence the financing opportunities, of the chartered banks, and only indirectly, if at all, on the financing opportunities available to competing institutions. Since these other institutions do not have statutory cash reserve requirements and are not bound by the 6% interest rate maximum, they are able, during a period when the authorities wish to contract or restrict the growth of credit, to continue to expand their credit operations and to take advantage of whatever may be the prevailing rate of interest. Since the central bank does not have the power to control their operations, even tighter restrictions have to be imposed on the chartered banks in order to keep the total amount of financing in the country within the limit desired by the central bank authorities. This is clearly a serious defect in the arrangements for implementing monetary policy, and one which imposes special costs and restrictions on the chartered banks, substantially limiting their ability to compete effectively.

94. Another important legal limitation on the competitive position of the chartered banks is the prohibition in the Bank Act of lending on the security of mortgages, with the exception of those insured under the National Housing Act. This prohibition means that the public is largely prevented, when seeking mortgage money, from approaching the chartered banks as one possible sourc of the funds required. The field is therefore left open to a range of other lenders who are inhibited neither by government regulation nor by the possibility of competitive action by the chartered banks.

95. Conclusion. What should be the goal of national policy in this whole matter of the type and variety of financial institutions available to serve the Canadian economy? It is our view that the goal should be to have a wide range and great flexibility in the financial services available to the Canadian public and that this can best be achieved by permitting the free play of com-

petitive forces among the various institutions involved, including the chartered banks, without discriminatory restrictions which work to the disadvantage of one type of institution. At the present time the chartered banks are prevented by various legal and institutional rigidities from competing fully and effectively with other institutions over the whole range of financing activities. This means that the Canadian public, in seeking to satisfy its various financial requirements, frequently finds that for certain of these requirements the chartered banks must be ruled out as possible suppliers. The result is that for a considerable range of financial activity the other institutions are sheltered from the competition which could otherwise be available from the chartered banks and which could not fail to strengthen the position of the Canadian public as it weighs and compares alternative sources of financing.

96. So far as possible the solution should lie in the direction of allowing free competition and the play of normal market forces as between competing financial institutions. Some regulations and controls there will undoubtedly be, intended either to safeguard the interests of the public or to facilitate the implementation of official monetary and fiscal policies. To the extent that this is practicable and possible, such controls and regulations should bear equally on all competitors in the field. From the point of view of competition with near-bank institutions, the preferable solution to the legal maximum interest rate problem would appear to be to give the banks the same competitive flexibility now enjoyed by the other institutions, i.e., to eliminate the legal maximum; and the banks so recommend. This, particularly if combined with the removal of limitations on lending powers, would permit the chartered banks to compete on equal terms with other institutions now attracting a rapidly growing share of the savings deposits and loanable funds of Canadians.

97. It may here be pointed out that in 1933, by a four-to-one

majority, the Royal Commission on Banking and Currency in Canada recommended the repeal of the statutory provision limiting the banks' lending rates. The four Commissioners expressed the opinion "that a statutory maximum rate of interest is nowadays anomalous and an undesirable interference with freedom of contract, and that the provision of the Bank Act limiting the rate of interest to seven per cent, whatever justification it may originally have had, ought now to be repealed." This recommendation was not acted upon, and in fact the ceiling was subsequently lowered to six per cent.

DEBT MANAGEMENT

98. In the period since the 1958 conversion loan there have been a number of changes in debt management policy and techniques. Although we are satisfied on the whole with the way debt management has been developing recently, it is open to some criticisms. The increased role of the Bank of Canada in taking on large blocks of new issues which are fed out to the market according to demand has been accompanied by more or less overt attempts on the part of the authorities to influence the selling behaviour of the dealers by inducing them to withhold new short-term issues from the banks and offer them instead to the non-bank market. This behaviour on the part of the authorities indicates preconceived ideas on their part regarding the appropriate maturity structure of the banks' portfolios. It is probably fair to say that the banks are unanimous in deprecating this practice. Even though it may generally be desirable to channel securities into non-bank hands it is our view that, once the terms of an issue have been decided upon, the market should operate freely in determining its distribution as between bank and other investors. Any other view of the market would imply the creation of rigidities and barriers between different types of investors, which would inhibit rather than assist the growth of an effective

market.

99. On the technical side the Bank of Canada has been accused of erratic behaviour in its after-market operations with those parts of new issues which it has taken up itself. The criticisms relate to the Bank's hours of trading, amounts of bonds offered at different times, and prices quoted. We are inclined to think that the Bank of Canada is seriously handicapped in its operations by being geographically separated from and out of touch with the major markets in Toronto and Montreal. The situation would be improved if the Bank were to maintain senior officers in both centres with sufficient authority to make on-the-spot decisions.

100. We believe that the system of Treasury bill auctions has worked well on the whole. In the past it has been suggested that all transactions should be put through dealers, and that banks should not bid directly for bills at the tender. We would not be in favour of such a change, as we think it important that the banks keep in close and active touch with the money market

101. We believe that the federal debt should continue to be managed by the Department of Finance, using the Bank of Canada in an advisory capacity only. We would not be in favour of setting up an independent body to make debt management decisions. Debt management techniques, however, would probably be improved if either the Department of Finance or the Bank of Canada were to consult banks and investment dealers and institutional buyers on a regular basis, as is done in the United States before the timing and terms of Government issues are decided.

<u>Techniques of Monetary Control</u>

102. <u>Cash Management</u>. To exercise control over the volume of bank credit, the central bank has only to regulate the supply of bank cash relative to the needs of the banking system for cash. The central bank, through its control of bank cash, can provide the banking system with surplus cash at any given moment,

thus permitting the system to expand. Or, the central bank can withdraw cash from the system leaving it with less cash than it requires, thus forcing the system to contract.

103. The best known technique that the central bank has for managing bank cash is open-market operations. These have the advantage that they can be made to operate smoothly and continuously so as to tailor cash changes as precisely as possible to fit the day-to-day needs of monetary policy. Other ways in which a central bank can supply or withdraw cash from the banking system are by extending the scope of its lending operations and by movements in government or other accounts carried by it. All these other methods of cash management are less satisfactory than open-market operations for they do not work through the market mechanism and they have an element of arbitrariness. They cannot be carried out as precisely as open-market operations, and they are less easy for the public to understand. Consequently it is preferable for a central bank to concentrate on open-market operations as its main instrument of cash management, resorting only to other techniques in situations in which the state of the money market restricts the use of open-market operations.

104. Reserve Requirements. In order to impose control over a banking system the central bank requires as a minimum the ability to supply or withdraw cash from the banking system. Another aid is often called upon to help in maintaining control over the banking system, namely, statutory cash reserve requirements. Such requirements work automatically to dampen fluctuations in bank deposits and assets.

105. Other Monetary Control Techniques. A liquid asset ratio is also sometimes introduced as an aid to monetary control. Such a ratio may be necessary when ordinary techniques of central bank cash management cannot be used to reduce the cash base of the banks, or to prevent them from adding to their loans, as for

example if the central bank is prevented from using open-market operations to maintain control over the banking system because of its concern for stable interest rates or for government financing. In such a situation, which is one in which the money market is not adequate for the open-market operations the central bank would like to carry out, a liquid-asset ratio may be a useful stop-gap measure. A better solution than the adoption for all time of a liquid-asset ratio, however, would be to find ways of developing a better money market. In the meantime a liquid-asset ratio should be retained for no longer than necessary, and there is certainly no need to give such a ratio legal status.

106. Other schemes besides cash or liquid-asset requirements could no doubt be devised as a means for implementing and aiding monetary control. Such requirements, however, are unnecessary when money markets are sufficiently developed to permit the central bank to exercise control through open-market operations. Hence, the emphasis in monetary control should be on bettering financial markets for making open-market operations more effective rather than devising new methods of control. Then the central bank will be able to exercise monetary control effectively by working on the supply of bank cash, using its open-market operations for this purpose.

107. Bank Rate. "Bank Rate", the minimum rate at which the Bank of Canada is prepared to make loans or advances, might be used to perform one or both of two distinct functions: to regulate the access of the money market to the central bank, and to provide a signal of central bank intentions. The present method of setting Bank Rate in Canada at 0.25% above the latest average yield on accepted tenders for Treasury bills performs the first or "penalty rate" function satisfactorily, for it makes borrowing from the central bank a more expensive way of raising cash than selling marketable securities or borrowing elsewhere, but it does

not perform the second or "signalling" function.

108. The effect of monetary control depends in no small part on the responsiveness of the banking system. In all systems there will be some lag between a change in monetary policy and the response of the banks and the public at large. In other words, there is more to central banking than merely pushing a button to move the banking system from one position to another. It follows that the response of the banking system to central bank control will be more rapid and appropriate if the banking system is informed of the direction in which the central bank is trying to move it. Therefore, a signal of central bank intentions adds to the efficiency of monetary control.

109. It is certainly important for a central bank to offer full explanations of its policy. The complexity of the modern financial environment makes it all the more imperative that the maximum of information be provided. But more than this is required for implementing monetary control. Bank Rate is the most widely accepted means of signalling central bank intentions. Qualitative statements and explanations while useful do not replace the need for indicating policy in terms of some significant economic or policy indicator. For such purposes statements concerning the money supply, national income, general prices, etc. to indicate intentions are too general, and these indicators are not sufficiently amenable to the control of the central bank to be a good signal. The level of bank cash is a better signal but is not as good as Bank Rate itself.

110. The basic problem in using Bank Rate as a signal is to do so without compromising its function as an appropriate penalty rate, which serves to restrict access to central-bank loans for last-resort situations. The present method of setting the Rate does not solve this problem. A return to the conventional Bank Rate, fixed at the discretion of the central bank, may not

solve it either. Having two rates, one as a signal and one as a penalty, is a possible solution. Another possibility is to continue to use a floating rate but to vary the spread between Bank Rate and the Treasury bill rate. Yet another possibility is to retain the floating rate in normal circumstances but to depart from it as necessary in order to provide a signal.

111. Bank Lending Rates. Under existing conditions of financial competition, flexible bank lending rates would serve as a useful means of furthering the needs of monetary policy In order to do this, however, the legal ceiling would have to be eliminated. Under present legislation when banks are unable to meet all the demand for loans their allocation of the inadequate supply of funds is made more difficult because they cannot make appropriate increases in lending rates. If the ceiling were removed the banks could pay more to their depositors, and would be able to compete more effectively with non-bank lenders, thus contributing to better monetary control.

112. Tied or Linked Rates. It has been suggested that bank lending rates or deposit rates, or both, should be tied to a conventional Bank Rate functioning as a signal of central-bank intentions along the lines of arrangements in England. Such arrangements are not as desirable as they may seem at first glance, and in fact they have serious disadvantages which lead the banks to oppose them. By its very nature Bank Rate at times will move ahead of the market and at other times will lag behind it, and any other rates tied to it would then be out of line with the market. Market forces cause bank lending and deposit rates to move more or less together anyway, but the spread naturally varies over the business cycle in a way that helps to stabilize monetary policy, and introducing a fixed spread would introduce unnecessary rigidities into the system. In any case it would place the chartered banks at a new competitive disadvantage if their lending or borrowing rates were linked to Bank Rate while the

rates of other institutions were left free to move with the market.

CONCLUSION

113. The banks have welcomed the opportunity provided by the preparation of this brief to make the thorough review of their basic functions that this enquiry involves. Such reviews are not by any means new to the banks because of the necessity of preparation for decennial revisions of the Bank Act. Nevertheless, on this occasion, when banking is being considered in the broader context of its relationship to the functions of other financial institutions, an introspective look at the role of banking takes on a special significance.

114. In making the observations and recommendations embodied in the brief, the underlying theme is the desire of the banks to maintain those basic standards of banking procedure which have earned for the Canadian banking system an enviable reputation for stability and soundness, while at the same time seeking to achieve a more flexible framework of operations within which the changing financial requirements of a developing Canadian economy may more fully be met.

115. In keeping with this approach we have made no specific recommendations in this brief regarding other financial institutions. Our preoccupation has been with the desirability of removal from the banks of what now appear to be outdated and unnecessary restrictions. This is not to under-emphasize the necessity of fundamental legislative and procedural safeguards, but, given the existence of these fundamental safeguards, it is our belief that the public interest will best be served by the widest possible area of flexibility for banks and other institutions alike.